Supreme Court of the United States

October Term, 1960

No.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE FOURTH CIRCUIT

INDEX.

	Page
CITATION TO OPINIONS BELOW	1
JURISDICTION	1
QUESTION PRESENTED	2
STATUTE INVOLVED	2
STATEMENT OF THE CASE	3
ARGUMENT FOR GRANTING OF THE WRIT	9
CONCLUSION	11
APPENDIX (OPINION OF THE COURT OF APPEALS FOR THE FOURTH CIRCUIT)	13

STATUTES CITED.

	Page
Internal Revenue Code of 1939, Section 23(a)(1)(A), 26 U. S. C. 1952 ed., Sec. 23	2, 9
28 U. S. C. 1254(1)	1, 2

IN THE

Supreme Court of the United States.

No.

OCTOBER TERM, 1960.

WEST VIRGINIA NORTHERN RAILROAD COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Citation to Opinions Below.

The Memorandum Findings of Fact and Opinion of the Tax Court of the United States (Transcript, pages 1-9) are not officially reported, but are unofficially reported by Commerce Clearing House at 18 T. C. M. 975 and by Prentice Hall at 1959 P-H T. C. Memo Dec. ¶ 59,204.

The Opinion of the United States Court of Appeals for the Fourth Circuit (Transcript, pages 23-28) has not as yet been officially reported, but has been reported unofficially by Commerce Clearing House at 60-2 U. S. T. C. ¶ 9702 and by Prentice Hall at 6 A. F. T. R. 2d 5557.

Jurisdiction.

The Judgment of the Court of Appeals was filed and entered September 19, 1960 and its Order Denying Petition for Rehearing was filed and entered January 10, 1961.

Jurisdiction is conferred upon this Court by 28 U. S. C., Section 1254(1).

"Sec. 1254. Courts of Appeals; certiorari; appeal; certified questions.

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree; * * *".

Question Presented.

The sole question involved is the right of a railroad, in computing its income taxes, to deduct reasonable rentals actually paid under contract for the use of the two locomotives which supplied the railroad's only motive power, as ordinary and necessary business expenses.

Statute Involved.

The statutory basis for the allowance of the deductions claimed by the Petitioner is to be found in Section 23(a)-(1)(A), Internal Revenue Code of 1939, 26 U. S. C. 1952 ed., Sec. 23.

"Sec. 23. Deductions From Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses—

"(1) Trade or business expenses—

"(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *"

Statement of the Case.

This proceeding involves Corporation Income Taxes for the calendar years 1951, 1952 and 1953 in the amounts of $11,355.42, $20,035.93 and $13,718.66 respectively.

The facts were substantially stipulated by the parties and are as follows:

West Virginia Northern Railroad Company, the Petitioner in this proceeding, is a corporation organized in 1883 with its principal place of business at Kingwood, West Virginia. It has consistently kept its books and prepared its income tax returns on a calendar year basis and employed an accrual method of accounting. Its tax returns for the years here involved were filed with the Office of the District Director of Internal Revenue at Parkersburg, West Virginia. Petitioner's business at all times here involved consisted of the operation of a railroad over 11 miles of track between the towns of Kingwood and Tunnelton, West Virginia, which line was a feeder road for the Baltimore and Ohio Railroad.

On June 14, 1946, four of the corporation's five stockholders were the owners of two diesel locomotives which they leased to the Petitioner on that date for a 5 year term under a written agreement of lease requiring rental payments monthly computed at the rate of 7½¢ per net ton of freight hauled by the Petitioner over its tracks. Under the lease agreement the Petitioner was required at its own expense to maintain the locomotives in good condition "wear and tear excepted" and at the end of 5 years to deliver them back to the lessors in good condition "damage by the elements excepted."

On December 30, 1950, the lessors each owned 100 shares of the Petitioner's outstanding capital stock. The only other stock outstanding consisted of 600 shares all of which were owned by James Jenkins, the father of the four lessors. On that date the 5 stockholders entered into a written agreement with the Preston Coal Company, a Missouri

Corporation, under which they granted to that corporation an option, exercisable on or before July 1, 1951, to purchase all of their stock in Petitioner for the sum of $500,000 provided the Preston Coal Company should simultaneously exercise an option independently acquired by it on the same day from the stockholders to lease or purchase approximately 25,000 acres of coal properties owned by the stockholders and located in Preston County, West Virginia.

In the stock option agreement it was provided that between December 30, 1950 and July 1, 1951, there should be no adverse changes in the balance sheet of the Petitioner, no changes in its capital structure, and that no extraordinary business should be transacted by it. It was further provided that, in the event the option should be exercised, the Preston Coal Company (or its assignee) would be required to agree to an extension of the diesel locomotive lease for a further term of 25 years provided certain minor amendments were made to the lease agreement. It was further provided that it would be agreed upon the expiration of the 25 year renewal period the Petitioner would be required to purchase the locomotives at their then fair market value.

On March 19, 1951, the Preston Coal Company assigned to Ralph R. Lewis all of its right, title and interest in and under both of the aforementioned option agreements. On or before July 1, 1951, Lewis notified the Jenkins family of his intention to exercise the options contained in the two option agreements of December 30, 1950.

Thereafter James Jenkins advised Lewis's attorney that he was greatly disturbed about the provisions of the stock option agreement because the Jenkins family did not have enough security under its terms. He threatened to refuse to carry out the agreement, stating that he would rather stand a loss than carry out an agreement which would give him and his children no protection. One of the points to which Jenkins was referring was that, although the stock was to be paid for in installments over a period of

15 years, with only $50,000 required to be paid down originally, the stock was to be turned over to Lewis in the first instance without any security lien. Furthermore, although the option agreement called for installment payments, it did not provide that the buyer should give the sellers any note for the unpaid balance. Furthermore, there was nothing in the agreement to prohibit the buyer from distributing all of the corporation's surplus to himself even though the stock had not yet been paid in full.

Due to the time consumed by conferences between the parties, they failed to consummate the transactions within the time limit set forth in the December 30, 1950, option agreements, but the time was extended by mutual agreement of the parties.

Lewis's attorney was sympathetic to some of the Jenkins' concerns, and he agreed to see that they had reasonable protection. He agreed that a note should be given and that the stock certificates should be pledged as collateral security for payment of the note. He also agreed to permit the Jenkins family to designate two of the five members of the Railroad's board of directors so long as the note had not yet been paid in full. In addition, and at their insistence, he agreed that there would be no increases in the salaries to be paid to the officers of the corporation and no dividends payable to the purchaser unless paid out of income earned after the sale of the stock. In addition, James Jenkins asked Lewis's attorney if he would agree that the rental to be paid by the corporation for the two diesel locomotives should be fixed at 12½¢ rather than at the 7½¢ rate contemplated in the option agreement and that the term of the lease be 15 years, without any right of cancellation on the part of the railroad except by purchasing the engines for $387,500.00 cash. Lewis's attorney refused to accede to this change because of the provision in the original option agreement which clearly contemplated that the 2 engines would be available to the corporation for 25 years at a rental of only 7½¢ per ton of freight hauled,

and the further provision contained therein to the effect that the financial condition of the company should not at settlement be materially worse than at the time the option agreement was executed in 1950;

Lewis's attorney advised the Jenkins family that such an increase in the rental charge would necessarily reduce the value of the corporation's stock and that the price to be paid by his client for the stock would, therefore, have to be reduced in a corresponding amount if any increase in the rental charge for the diesels was to be made; otherwise Lewis could not be required to pay the option price for the stock. The Jenkins family said that they wanted the rental rate increased and would agree to the corresponding reduction in the purchase price of the stock.

These points having been finally agreed upon, the parties on September 24, 1951, embodied them in several amendatory agreements, together with certain other amendments pertaining to the lease of the coal lands. Under the amendatory agreements the Railroad was not to be required to purchase the two locomotives at the termination of the 15 year period as had been the case under the original option agreement; but instead could turn them back to the owners.

These amendatory agreements further provided that the amount due by Lewis on the note given to the Jenkins family to cover the price of the stock to be purchased should be reduced from time to time by the amount of all locomotive rentals payable by the Railroad in excess of the original 7½¢ per ton rate.

It was further provided that at the time of settlement the Jenkins family would loan to Lewis the sum of $90,000.00 to be used by him to make the $50,000.00 initial payment required on the stock purchase, a $20,000 initial payment required on the lease of the coal properties and $20,000.00 to pay the costs and expenses of bankers with whom Lewis had been dealing in the transaction. It was agreed that this $90,000.00 should be included in the

same note with the $450,000.00 balance of the purchase price of the stock so that the total amount of indebtedness to be evidenced by the note of Lewis to the Jenkinses would be $540,000.00. The note was to bear interest at the rate of two per cent (2%) per annum and call for annual payments of $34,666.66 for 15 years and, in addition, for a $20,000.00 payment 18 months after the note was executed.

On the same day, the Board of Directors of the Railroad (consisting of the members of the Jenkins family) met and adopted on behalf of the corporation the new locomotive lease agreement calling for rental payments monthly at the rate of 12½¢ per ton of freight hauled over the line for a period of 15 years. Because the old lease had expired by its terms on June 13, 1951, while the parties were negotiating, the new lease was made effective retroactive to June 14, 1951.

The amount of additional rental for the two locomotives for the period from June 14, 1951 to September 24, 1951, at the 12½¢ rate as compared to the old 7½¢ rate was $9,953.75.

Settlement was then held and Lewis gave his note, dated September 24, 1951, in the amount of $540,000.00 to the Jenkinses.

Each month, thereafter, a statement of the number of tons of coal shipped over the Railroad was prepared and sent to the Jenkins family, showing the total rental payment due and specifying the amount thereof in excess of the old 7½¢ rate by which Lewis's note was to be reduced. The rental was paid monthly by the Railroad corporation at the same time. At the request of the 4 members of the Jenkins family who were the owners of the two locomotives, the rental was paid each month by the issuance of 5 checks, each for exactly ⅕ of the monthly rental, the fifth check being made payable to James Jenkins, the father.

The rentals payable under the locomotive lease for the years 1950-1953, inclusive were:

1950	7½¢ rate	$73,021.00
1951 prior to 6/14	7½¢ rate	$21,439.72
1951 after 6/13	12½¢ rate	$49,956.00
1952	12½¢ rate	$91,019.75
1953	12½¢ rate	$73,976.15

Under the September 24, 1951, agreement the following portions of the above rentals were required to be, and were in fact, applied in reduction of the installments due on the $540,000.00 note:

1951—$19,982.40
1952—$36,407.94
1953—$29,590.43

All rentals payable were in fact paid as above set forth monthly as soon as the amounts could be determined from the Railroad's books. The two diesel locomotives were the sole locomotive power used by the petitioner in its operations during the taxable years here involved.

In the annual reports which the Railroad filed with the Interstate Commerce Commission for the years here involved it reported the entire amount of locomotive rentals at the 12½¢ rate as "Rent for locomotives." It did likewise in its corporate income tax returns for those years.

The negotiations between the parties were carried on at arm's length. (This conclusion of fact is amply supported by the testimony of W. B. Saul, the only witness whose testimony was heard.)

The Respondent does not challenge the reasonableness of the 12½¢ rentals. On the contrary, he concedes that there is no issue of reasonableness here.

The amounts claimed as deductions for locomotive rentals during the taxable years here involved were in fact expenses of the taxpayer accrued during those years for the rental of its two locomotives and, as such, constituted ordinary and necessary business expenses.

That portion of the rental payments attributable to the 5¢ increase was disallowed by the respondent as an in-

come tax deduction. A petition for review of the respondent's action was timely filed with the Tax Court of the United States.

A Memorandum Opinion (T. C. Memo. 1959-204), sustaining the Respondent's position was filed by the Tax Court October 28, 1959. Decision for the Respondent pursuant thereto was entered by the Tax Court October 30, 1959.

A Petition for Review of that decision by the United States Court of Appeals for the Fourth Circuit was filed January 29, 1960.

An Opinion sustaining the decision of the Tax Court was filed by the Court of Appeals September 19, 1960, and the Judgment of that Court was filed the same day.

A Petition for Rehearing (Transcript, pages 30-34) was filed by Petitioner October 18, 1960 with the Court of Appeals. On January 10, 1961, the Court of Appeals filed its "Order Denying Petition for Rehearing" (Transcript, page 35).

Argument for Granting of the Writ.

The decision of the Court of Appeals sustaining the decision of the Tax Court should be reviewed and reversed by this Honorable Court, since it decides a federal question in direct conflict with the clear and unambiguous language of a federal statute. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, set forth above, states that "In computing net income *there shall be allowed as deductions* * * * the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * *rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.*" (Emphasis supplied.)

The statute does not say that the Respondent may allow or disallow deductions for rental payments in his discretion. If the expenses of a taxpayer are in fact rentals, constituting ordinary and necessary business expenses, then the statute requires that they shall be allowed as deductions in computing the net income of the taxpayer. Of course, the taxpayer cannot convert nondeductible items into deductible items by calling them "rent" when they are not rent in fact, nor can he properly deduct excessive amounts merely by disguising some other form of nondeductible payments as rents. *But the amounts paid by the West Virginia Northern Railway Company for the lease of its only two locomotives are conceded to have been reasonable*, and nowhere is it suggested that they were not rental payments. Under these circumstances it is submitted that the taxpayer was and is entitled to the deductions claimed as a matter of law.

The decision appealed from countenances the arbitrary action of the Commissioner of Internal Revenue in deliberately withholding a right prescribed by a federal statute. Such action is in conflict with the law and is of great importance not only to the Petitioner, but to numerous taxpayers whose reliance on statutory language is jeopardized by judicial approval of arbitrary administrative departures from statutory rules.

The Court of Appeals indicates that substance rather than form must prevail; and with this Petitioner agrees heartily. It is submitted, however, that the Court was misled by the fact that the rental payments in question served a secondary purpose in measuring the price ultimately to be paid for the railroad. The fact that the volume of freight hauled by the locomotives was used as a formula for computing the purchase price seems to have disturbed the Court. Thus, when the purchase price was reduced 5¢ for each 5¢ increment of rent paid, the Court speaks of the rents as "a device for the payment of an obligation of Lewis," and consequently approves of disallowing the deduction for rent.

There is nothing mysterious about crediting the 5¢ increments against the purchase price. When the sale of the railroad was contemplated, the buyers were willing to pay a certain price for the entire package, including the right to use of the locomotives at 7½¢ per ton of freight hauled for 25 years. *They were naturally unwilling to pay the same price when the sellers raised the locomotive rent to 12½¢ and shortened the term of the lessee to 15 years.* The reduction of the amount they were then willing to pay was tied directly to the future use of the locomotives.

None of this changed the basic fact that the 12½¢ rent continued to be rent for essential equipment at a reasonable rate, clearly deductible under the statute.

Conclusion.

For the foregoing reasons, this petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit should be granted.

Respectfully submitted,

ALLEN S. OLMSTED, 2ND,
Attorney for Petitioner.

APPENDIX.

Opinion of the United States Court of Appeals for the Fourth Circuit.

(Caption omitted.)

SOPER, Circuit Judge: In this case review of the decision of the Tax Court [CCH Dec. 23,819(M)] is sought, wherein the court upheld the determination of the Commissioner of Internal Revenue of deficiencies in the income tax returns of West Virginia Northern Railroad Company for the years 1951, 1952, and 1953 in the respective amounts of $11,355.42, $20,035.93, and $13,718.66.

The taxpayer railroad company operates eleven miles of track between Kingwood and Tunnelton, West Virginia, as a feeder of the B. & O. Railroad Company. The stock of the corporation, amounting to 1,000 shares, was owned in 1951 and prior years by James Jenkins and his four children, 600 shares by him and 100 shares each by a son and three daughters. The Jenkins family also owned two diesel locomotives which, on June 14, 1946, they had leased to the railroad for five years at a haulage rental of 7½ cents per ton. These locomotives furnished the sole motive power of the railroad. The family also owned 2,500 acres of coal land in Preston County, West Virginia.

On December 30, 1950, the Jenkins family granted two options to the Preston Coal Company exercisable on or before July 1, 1951. The first option provided that the coal company might purchase all of the stock of the railroad company for $500,000 of which $50,000 should be paid in cash and the balance in fifteen annual instalments. The option also provided that in the event of exercise the purchaser would take a twenty-five year extension of the locomotives lease at the 7½ cents per ton rate and that there would be no adverse change in the taxpayer's balance

sheet and no change in the capital structure during the option period. This option, however, was subject to the condition that the coal company would also exercise the second option whereby it acquired the right to purchase the coal land for $50.00 per acre or, in the alternative, to lease the property at a royalty of 10 cents per ton mined and sold, with a minimum royalty of $30,000 per year. On March 19, 1951, the coal company assigned its rights in these options to Ralph R. Lewis and Lewis, on or before July 1, 1951, notified the Jenkinses of his intent to exercise both options.

Thereafter the transactions occurred which gave rise to the present controversy. James Jenkins was dissatisfied with the terms of the option agreements and so notified Walter Biddle Saul, the attorney for Lewis. He was disturbed by the provision of the agreements that the stock was to be turned over to Lewis upon the payment of only $50,000 without any note or any security for the payment of the instalments, and with nothing in the agreements to prohibit the buyer from distributing the surplus of the corporation to himself even though the stock had not been paid for in full. Accordingly, the agreements were altered to meet these objections. A note was given for the purchase price of the stock and the stock was deposited as collateral for the payment of the note and it was agreed that there would be no increases in the salaries paid to the officers of the corporation and no dividends declared unless they were paid out of income earned after the sale of the stock. In addition, there was added a provision to the effect that the rental to be paid by the corporation for the locomotives should be fixed at 12½ cents instead of 7½ cents per ton as contemplated in the original agreement, and that the additional 5 cents per ton should be credited against any instalment payment due by Lewis on the purchase price of the stock of the railroad, and if no instalment was due then the additional 5 cents per ton should be credited against the minimum royalty due by Lewis under the lease of the coal

lands. Thereafter, in September 1951, and in each following month, the taxpayer rendered statements to members of the Jenkins family showing the number of tons shipped over the line and, in addition, the amount due them on account thereof and the portion attributable to the 5 cents per ton increase. For the years in question the following sums were thus received or accrued by the Jenkins family:

Taxable Year	Amount at 7½ cent rate	Amount at 5 cent rate
1951	$53,500.56	$19,982.40
1952	56,170.83	36,407.94
1953	45,965.20	29,590.43

The amounts represented by the 5 cents per ton factor during each of these years were credited against the instalment due from Lewis on his note in connection with the stock purchase.

The taxpayer on its federal income tax returns for these years deducted the full amount of the payments made at the 12½ cents rate as rent for the locomotives, but the Commissioner disallowed that portion of the payments which represented the additional 5 cents per ton. Consequently, the question to be decided is whether the additional sum of 5 cents per ton should be deducted from the taxpayer's income as an ordinary and necessary expense of operation of the railroad or should be considered as a payment by Lewis on account of the purchase price of the railroad company's stock.

The taxpayer contends that it is clearly entitled to deduct the entire 12½ cents per ton charge from its gross income under the provisions of § 23(a)(1)(A) of the Internal Revenue Code of 1939, which permits the deduction of all the ordinary and necessary expenses paid or incurred by a taxpayer in the taxable year in carrying on a trade or business. It is pointed out that the two locomotives constituted all the motive power available to the railroad and that it was conceded at the trial below that the rental of 12½

cents per ton of coal carried was a reasonable charge for this service. Hence it is said that the deductible character of the expenditure is clearly established.

The argument is not without force if attention is confined to the facts which it recites; but these constitute only a part of the picture. The modified agreements did indeed provide that the additional 5 cents per ton should be paid as rent for the use of the locomotives, and it was actually paid into the hands of Jenkins and his children in equal shares; * but it was stipulated that the payments should be credited upon the purchase price of the stock, and this was actually done. In other words, the additional sum was not applied by the Jenkinses to the payment of a debt due them by the railroad company in its corporate capacity but to the payment of a debt due them by Lewis in his individual capacity. In effect, a portion of the earnings of the railroad was pledged to the former stockholders of the taxpayer corporation so as to support Lewis's obligation to pay them for their holdings.

Accordingly, we think there was ample ground for the finding of the Tax Court that the increase in the rental did not constitute an ordinary and necessary expense of the taxpayer corporation but was rather a device for the payment of an obligation of Lewis. It is well settled that in matters of taxation substance rather than form prevails and that the taxability of a transaction is determined by its true nature rather than by the name which the parties may use in describing it. Thus, in *Beus v. Commissioner*, 9 Cir., 261 F. 2d 176 [58-2 USTC ¶ 9945], the deduction of so-called rental payments under a farm lease with option to buy was disallowed when it appeared that the payments

* The record is not entirely clear as to whether the locomotives belonged to Jenkins and his four children or solely to the children. The lease of June 14, 1946, was signed by the four children as lessors and by the father as president of the lessee corporation. The modifying agreement of September 24, 1951, on the other hand, named the five as the owners of the locomotives. It was stipulated by the parties, however, that the locomotives belonged to the four children, and yet the additional rental of 5 cents per ton was divided equally among the five. The only explanation offered was that the Jenkins family wanted it done that way.

were actually made as part of the purchase price of an interest in the property; in *Helvering v. Richmond F. & P. R. Co.*, 4 Cir., 90 F. 2d 271 [37-2 USTC ¶ 9353], payments of so-called "guaranteed dividends on guaranteed stock" by a corporation were held to be deductible since it was shown that the sums paid were in truth interest on a corporate debt, the court stating that the question was to be decided not by the names used by the parties to describe the transaction but by the nature and incidents of their rights in the stock; and in *Brush-Moore Newspapers, Inc. v. Commissioner*, 6 Cir., 95 F. 2d 900 [38-1 USTC ¶ 9247], deduction of payments by a corporation which were described as salary for services was denied when it was found that the payments were part of the purchase price of corporate stock. For like reasons the decision of the Tax Court in the pending case will be affirmed.

Affirmed.